Gerry Smedinghoff
Senior Associate

Government Human Services Consulting
3131 East Camelback Road, Suite 300
Phoenix, AZ 85016
602 522 6500 Fax 602 957 9573

MERCER

MARSH MERCER KROLL
GUY CARPENTER OLIVER WYMAN

August 31, 2010

Ms. Joan Agostinelli
Office Chief
Arizona Department of Health Services
Office for Children with Special Health Care Needs
Children's Rehabilitative Services
150 N. 18th Avenue, Suite #330
Phoenix, AZ 85007-3243

Final and Confidential

Subject: Title XIX, Title XXI and Proposition 204 Capitation Rates for Contract Year 2011

Dear Ms. Agostinelli:

The Arizona Department of Health Services (ADHS), Office for Children with Special Health Care Needs (OCSHCN), Children's Rehabilitative Services (CRS) program contracted with Mercer Government Human Services Consulting (Mercer), part of Mercer Health & Benefits LLC to develop capitation rates for the Title XIX, Title XXI and Proposition 204 populations. These rates are used by the Arizona Health Care Cost Containment System (AHCCCS) to compensate CRS and the CRS contractor for CRS members who are Title XIX, Title XXI or Proposition 204 eligible during the Contract Year. For the Contract Year beginning October 1, 2010, and ending September 30, 2011 (Contract Year End (CYE) 2011), Mercer has developed capitation rates following the process described in this letter.

Background

CRS is primarily a children's program for Arizona residents under the age of 21 with chronic and disabling, or potentially disabling, conditions. The program provides services through one statewide contractor. Medical services not related to a child's CRS-eligible condition are provided through the child's AHCCCS health plan.

Three capitation rates are developed for compensating the CRS contractor based upon a member's CRS enrollment diagnosis. The three rates represent compensation for providing services to members with specific diagnoses that have historically represented relatively high, medium and low costs to the CRS contractor. The High, Medium and Low capitation risk group structure includes small numbers of the Qualified Medicare Beneficiary (QMB)

Plus, Medicaid [non-QMB and non-Specified Low-income Medicare Beneficiary (SLMB)] and SLMB Plus dual eligible populations. No other dual eligible populations are enrolled in the program. In Mercer's opinion, the High, Medium and Low capitation rate cells most appropriately match payment with risk in the CRS program, and hence provide a greater level of actuarial soundness than other approaches. The three-tier rate structure will continue to be used for CYE 2011.

CYE 2011 Capitation Rate Development Methodology – Overview

CYE 2011 marks the sixth year that contractor encounters have been used as the base data source. The CYE 2011 rates have been re-based.

Base Data

The CYEs 2008 and 2009 contractor encounter data were valued using a combination of contractor paid amounts and Medicaid (AHCCCS) fee schedule allowed amounts, incorporating a methodology in conjunction with Third Party Liability (TPL) cost avoidance and any pay-and-chase recoveries. CYE 2008 encounters were trended forward to a "modeled CYE 2009" level and blended with the actual CYE 2009 encounters to further enhance the credibility of the base data.

With three years of encounter data, CYE 2007 through CYE 2009, CRS Administration and Mercer performed a thorough analysis and kept the High, Medium and Low diagnostic groupings consistent with the prior year.

The CRS program falls under Arizona's 1115 waiver. Mercer performed a review of the CRS subcontractor submitted data and determined that the data included a small amount of non-covered services, which have been excluded from the base data.

Base Data Adjustments

1. Unpaid Claims Liability

The CYE 2008 and 2009 base data consist of encounters with dates of service beginning October 1, 2007, and ending September 30, 2009. Encounters were analyzed with a run-out

period of six months beyond the September 30, 2009 endpoint, from data extracted in April 2010.

The next step in the base data analysis process was a review of the CRS contractors' expense component for claims incurred but unpaid, hereinafter called the unpaid claims liability (UCL). The UCL is the sum of claims incurred but not reported, plus those claims reported but not yet paid. Statutory accounting recognizes an incurred medical expense for the period as the result of the sum of claims paid in the period, plus the change in the accrued liability for the UCL between the beginning and the end of the period. This calculation pushes the correction of the estimation error of the beginning UCL into the expense recognized in the current period. However, the expense that should be recognized in base data development is calculated from claims incurred in the CYEs 2008 and 2009 experience period, both claims paid in CYEs 2008 and 2009 and the accrued liability for the UCL as of the end of CYE 2009.

A review of the contractors' CYE 2009 encounters indicated that there were outstanding claims as of the April 2010 data extract. The overall adjustment for CYE 2009 encounters received beyond the April 2010 data extract was approximately $1.4 million, or 0.9 percent, over the two-year base period.

2. Completion for "Omissions"

As part of its 1115 waiver provisions, AHCCCS performs annual data validation studies of encounters. AHCCCS tests for completeness, accuracy and timeliness of encounter submissions based upon statistically valid sampling of both professional and facility encounters, comparing them against medical records. Mercer used the results of the most recently completed data validation study to develop factors to apply to the base CRS data to further complete the encounters for these "omissions." Mercer and CRS Administration used (with some downward adjustment which lowered the overall impact) the factors shown by AHCCCS, which vary between facility and professional consolidated categories of service (COS). The overall impact of this correcting adjustment is approximately $2.0 million, or 1.3 percent, for CYE 2008. No data validation adjustment was applied to CYE 2009 encounters because APIPA provided the source encounter data directly.

3. AHCCCS Inpatient Outlier Methodology Change

Starting on October 1, 2007, AHCCCS began a three-year phase-in of a new inpatient outlier methodology (specific to the cost-to-charge ratios used to qualify and pay outliers). CYE 2010 marks Year 3 of the phase-in, so the outliers in the base CYE 2008 and CYE 2009 encounters were re-priced using the new methodology. This change reduced the two-year base data by approximately $1.6 million, or 1.1 percent.

The following table summarizes the adjustments to the two-year base data.

Base Data Adjustment	Dollar Impact	Percent Impact
Unpaid Claims Liability	$1.4 million	0.9%
Completion for “Omissions”	$2.0 million	1.3%
IP Outlier Methodology Change	($1.6 million)	(1.1%)

Trend to CYE 2011

The CYE 2008 trended (modeled CYE 2009) and CYE 2009 encounter cost data were trended forward 24 months to CYE 2011. The trend factors recognize changes in cost-per-service unit and utilization of health care services from the CYEs 2008 and 2009 base period to CYE 2011. Unique trends were applied separately for ten COS. Trends were developed separately for the first 12 and last 12 months of the 24-month period to account for the unit cost rate caps and reductions mandated by the State legislature effective on October 1, 2009 and 2010. Inpatient and outpatient facility unit cost were frozen at 0.0 percent for both CYE 2009 and 2010, while most of the COS unit cost trends reflect a -5.0 percent reduction effective October 1, 2009. The weighted annual trend adjustment for CYE 2008 and CYE 2009 to CYE 2011 was 1.9 percent (2.9 percent utilization and -0.9 percent unit cost).

Mercer relied heavily on historical CRS encounter information as well as its professional experience in working with other state Medicaid programs, outlooks in the commercial marketplace that influence Medicaid programs, regional and national economic indicators and general price/wage inflation in developing trends. The 1.9 percent annualized weighted trend compares favorably with (is lower than) historical experience trend. Mercer believes the final trend factors selected to be reasonable and appropriate.

Service Utilization and Technology Changes from Base Data to CYE 2011

Service utilization increases and technology changes not reflected (or not fully reflected) within the CYE 2008 base data will impact the CRS contractor for CYE 2011. Adjustments for CYE 2011 were made only to the CYE 2008 base data for the following items through analyzing data from CRS, the AHCCCS contractors and external sources:

1. Biotech Drugs

Effective CYE 2009, the coverage of the high-cost drugs Aldurazyme, Cerezyme, Elaprase, Fabrazyme, Myozyme and Orfadin was transferred from AHCCCS to CRS. To best account for the actual costs of these new drugs, along with the uniform pricing of the new statewide pharmacy vendor contract, pharmacy utilization and costs for CYE 2008 data under the prior contractors were ignored and CYE 2009 encounters were weighted in the model at 100 percent. Thus, no adjustment was necessary to account for this new benefit in CYE 2009.

2. Cochlear Implants

Effective CYE 2009, the coverage of cochlear implants and related services was transferred from AHCCCS to CRS. The total impact of this change is approximately $761,000, or 1.0 percent, of the CYE 2008 base period.

Effective CYE 2011, the standard of care for cochlear implants will be expanded to include both ears, instead of only one. The cost of this change is calculated as the incremental increase of surgeries for one implant to two implants for those who normally would receive a cochlear implant during the year, plus the cost of additional cochlear implants into the second ear for some children who already have implants in one ear. The total impact of this change is approximately $1,550,000 or 1.1 percent of the two-year base period data.

3. Motorized Wheelchairs

Effective CYE 2009, the coverage of motorized wheelchairs related to CRS eligible conditions was transferred from AHCCCS to CRS. The total impact of this change is approximately $286,000, or 0.4 percent, of the CYE 2008 base period.

4. CRS Related Conditions

Effective CYE 2009, the coverage of conditions related to or caused by CRS conditions (e.g., diabetes caused by cystic fibrosis and failure to thrive caused by Cerebral Palsy) was transferred from AHCCCS to CRS. The total impact of this change is approximately $64,000, or less than 0.1 percent, of the CYE 2008 base period.

5. Therapies

Effective CYE 2009, the CRS limit of 24 therapy sessions was lifted. The total impact of lifting the limit is estimated to be $6,000, or less than 0.01 percent, of the CYE 2008 base period.

6. Emergency Services

The new CRS contractor has a significantly expanded hospital network as compared to the previous contractors which comprise the CYE 2008 base data. As a result of this, the Contractor is financially responsible for coverage of the related emergency services (that result in an inpatient admission) in those facilities effective CYE 2009, previously covered by AHCCCS non-CRS Contractors. The total impact of this change is $830,000, or 1.2 percent, of the CYE 2008 base period.

7. Transfer Outpatient Emergency Services to AHCCCS

Costs for outpatient emergency services, which do not result in a hospital admission were transferred from the CRS contractor to the AHCCCS contractors effective October 1, 2009. The total impact of this change is approximately $71,000 or 0.1 percent, of the CYE 2008 base period and $73,000 or 0.1 percent of the CYE 2009 base.

The following table summarizes the future benefit adjustments to the CYE 2008 and CYE 2009 base data.

Benefit Adjustment	CYE '08 Dollar Impact	Percent Impact	CYE '09 Dollar Impact	Percent Impact
Biotech Drugs	N/A	N/A	N/A	N/A
Cochlear Implants	$1,400,000	2.0%	$780,000	1.1%
Motorized Wheelchairs	$286,000	0.4%	N/A	N/A
CRS-Related Conditions	$64,000	0.1%	N/A	N/A
Therapies	$6,000	< 0.1%	N/A	N/A
Emergency Services	$830,000	1.2%	N/A	N/A
OP ER Transfer to AHCCCS	($71,000)	(0.1%)	($73,000)	(0.1%)

Loading for Contractor Administration and Underwriting Profit/Risk/Contingency

The overall CYE 2011 administrative expense load for the CRS Contractor is 9.6 percent. This represents no change from the CYE 2010 loading.

An underwriting profit/risk/contingency loading of 2.0 percent was applied uniformly to all rates. There should be an assumed margin for contribution to entity surplus and adverse claim risk contingency. The 2.0 percent represents a 0.5 percent increase from CYE 2010 and restores the loading to the CYE 2009 level. The risk-sharing mechanism, risk corridor, allowing the State and the contractor to share in gains and losses, has been eliminated for CYE 2011.

CRS Administration

AHCCCS has placed CRS Administration at risk for the provision of CRS-covered services for CYE 2011. Accordingly, the capitation rates were developed to include compensation to CRS for the cost of ensuring the delivery of all CRS-covered services. The capitation rates paid to CRS include a 4.4 percent administrative load. This is down from the 5.6 percent load

for CYE 2010. The administrative load represents the CRS costs of ensuring the efficient delivery of services in a managed care environment and is based upon historical CRS costs and accounts for continued regulatory oversight cost expectations for CYE 2011.

Reinsurance Offset

CRS Administration has negotiated a reinsurance arrangement with AHCCCS for CYE 2011 that remains the same as it was in CYE 2009 and CYE 2010. The arrangement covers inpatient claims exceeding $75,000 at 75 percent reimbursement. It also covers the high-cost biotech drugs Aldurazyme, Cerezyme, Elaprase, Fabrazyme, Kuvan, Myozyme and Orfadin at 85 percent reimbursement. Mercer estimated the value of the reinsurance by analyzing data from CRS, the CRS contractor, the AHCCCS contractors and external sources. Reimbursement amounts were estimated for the High, Medium and Low risk groups for CYE 2008 and CYE 2009 and each was trended forward to the CYE 2011 time period. These totals were then blended using a 50-50 weighting on projected CYEs 2008 and 2009 base data.

Hospital Reimbursement and Other Reductions

AHCCCS is anticipating implementation of significant reductions to inpatient and outpatient hospital reimbursement via rate reductions and adult benefit limitations on April 1, 2011. Other provider types may also be impacted by sizeable rate reductions. AHCCCS expects that the capitation rates for all affected risk groups will be adjusted via a January 1, 2011 contract amendment, to account for the savings resulting from these reductions to hospital reimbursement and other possible services. A contract amendment including revised rates is anticipated to be submitted to CMS for approval no later than December 1, 2010.

Certification of Rates

In preparing the Title XIX, Title XXI and Proposition 204 CRS capitation rates shown below, Mercer has used and relied upon enrollment, eligibility, claim, reimbursement level, benefit design and financial data and information supplied by the State. The State is responsible for the validity and completeness of this supplied data and information. Mercer reviewed the data and information for internal consistency and reasonableness but did not audit it. In Mercer's opinion, it is appropriate for the intended purposes. If the data and information are incomplete or inaccurate, the values shown in this report may need to be revised accordingly.

Mercer certifies that the CYE 2011 rates, including any risk-sharing mechanisms, incentive arrangements, or other payments, were developed in accordance with generally accepted actuarial practices and principles and are appropriate for the Medicaid covered populations and services under the CRS contract. The undersigned actuary is a member of the American Academy of Actuaries and meets its qualification standards to certify to the actuarial soundness of Medicaid managed care capitation rates.

Rates developed by Mercer are actuarial projections of future contingent events. Actual Health Maintenance Organization (HMO) costs will differ from these projections. Mercer has developed these rates on behalf of the State to demonstrate compliance with the Centers for Medicare and Medicaid Services (CMS) requirements under 42 CFR 438.6(c) and in accordance with applicable law and regulations. Use of these rates for any purpose beyond that stated may not be appropriate.

HMOs are advised that the use of these rates may not be appropriate for their particular circumstance and Mercer disclaims any responsibility for the use of these rates by HMOs for any purpose. Mercer recommends that any HMO considering contracting with the State should analyze its own projected medical expense, administrative expense and any other premium needs for comparison to these rates before deciding whether to contract with the State.

This certification letter assumes the reader is familiar with the CRS program, Medicaid eligibility rules and actuarial rating techniques. It is intended for the State and CMS and should not be relied upon by third parties. Other readers should seek the advice of actuaries or other qualified professionals, competent in the area of actuarial rate projections, to understand the technical nature of these results.

Risk Category	High	Medium	Low
Statewide Rates	$1,124.82	$550.67	$267.05
AHCCCS Reinsurance	($307.17)	($14.34)	($2.51)
Net Rates After Reinsurance	$817.65	$536.33	$264.54

If you have any questions or would like to discuss this information further, please call me at +1 602 522 6555.

Sincerely,

Gerry Smedinghoff, ASA, MAAA

Copy:
Cynthia Layne; David Reese – ADHS
Branch McNeal; Michael Nordstrom; Lisa Deyer – Mercer

Attachments